

Market watch

June 2010

Key points

- There was a degree of pessimism in the markets in relation to the global economic outlook with weaker data released.
- This saw a further sell off of risk assets with equity markets falling.
- In Australia a change in Prime Minister saw a new mining tax proposed in early July.

Economic overview

It was a disappointing end to the financial year for risk assets and investment markets in general. After a positive start to 2010 and relative optimism about the global economic recovery, pessimism and concerns over a 'double-dip' recession overtook sentiment in the last months of the financial year.

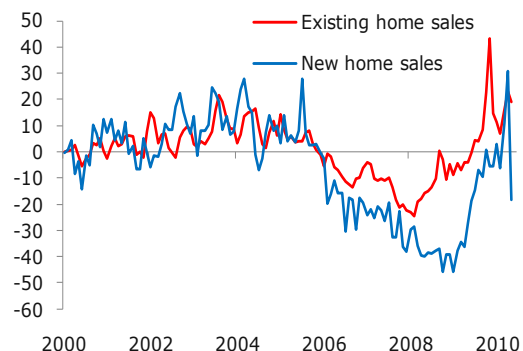
Equity markets continued to retreat in June, while a flight to quality saw government bonds rally sharply, with yields in the US and Germany falling to their lowest levels in over 12 months. Driving losses in equity markets were concerns over tightening financial conditions and lack of bank lending, financial re-regulation and the impact on global growth of the need to significantly reduce the size of budget deficits. There appears to be a crisis of confidence in terms of the economic recovery and this has fuelled and compounded the losses in risk assets.

Economic commentary within the market concentrated on a possible 'double-dip' recession for the global economy. The main arguments behind this include strict and "pre-emptive measures to reduce budget deficit levels in Europe and the UK, tightening financial conditions and recent softer economic data out of the US, Europe and even China. While these factors are cause for concern, it is important to remember that the global economy and companies are in a much

stronger position than during the global financial crisis. Businesses have recapitalised, household net wealth and income levels are rising and monetary policy is still extraordinarily accommodative. All these factors should prove supportive of economic growth in the second-half of 2010.

The US economy remains mixed. Strength has continued in the manufacturing sector, driven by low inventories, rising demand and the need for capital expenditure to replace inefficient and unproductive assets. However some headwinds for the US economy remain, including tight financial conditions, minimal credit flow within the economy and a still very weak housing sector. Over the month of May new (-32.7%/mth) and existing (-2.2%/mth) home sales fell with the expiration of the tax credit at the end of April (see chart below), housing starts also fell 10.0%/mth. In the near term, further weakness is expected as the tax credit brought forward home buyers, but affordable housing, rising demand and relatively low mortgage rates should help to lift demand later in 2010.

Annual growth in house sales



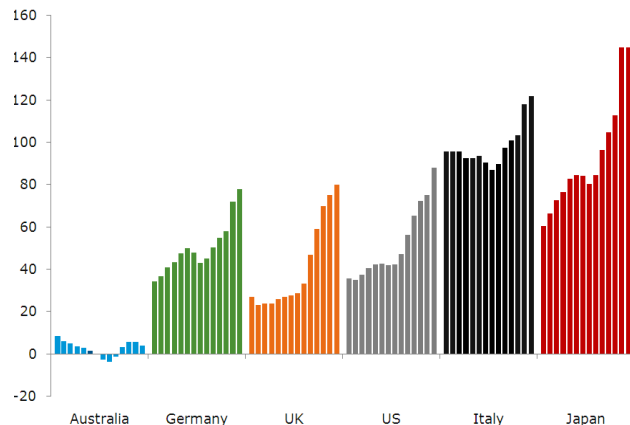
Source: Colonial First State Global Asset Management

The US employment data rattled markets in June with 431,000 jobs added compared to market expectations of 536,000. The disappointment was driven by private payrolls, with just 41,000 jobs added versus 180,000 expected, signaling businesses may have been reluctant to hire given a lack of confidence in economic conditions (the remainder of the payrolls was temporary hiring due to the US Census). Looking forward, employment data will continue to be a key indicator to watch for signs of expansion in the US and provide direction on possible interest rate moves by the Federal Reserve.

Also on the weaker side was consumer confidence (impacted by the oil spill in gulf of Mexico and European growth and debt issues), retail sales and inflation. There continues to be a lack of pricing pressure in the US economy which continues to be one issue the US Federal Reserve is watching closely when evaluating when to begin to lift official interest rates. The Federal Reserve left rates on hold at just 0%-0.25% and retained its expectation that rates would be on hold for an extended period of time, financial markets have pushed out any chance of a move till 2011.

Other international economic news focused on fiscal consolidation and the move by China to a more flexible exchange rate regime. The G20 summit took place in Toronto with the focus on finding the right balance between reducing government deficit and debt levels and ensuring the global economy returns to growth. One clear outcome of the meeting was the commitment by advanced nations to reduce government budget deficit levels in half by 2013 and stabilise or reduce government debt levels by 2016 (see chart opposite of major economies debt levels as a percentage of GDP). The G20 have committed doing this in a 'growth friendly' way and should be done on a country by country basis given the recovery is uneven and fragile and unemployment remains at unacceptable levels in many countries.

**General Government net debt (% GDP)
2000-2001, 2014**



Source: OECD till 2008, 2009, 2010, 2014 forecasts from the Commonwealth Government

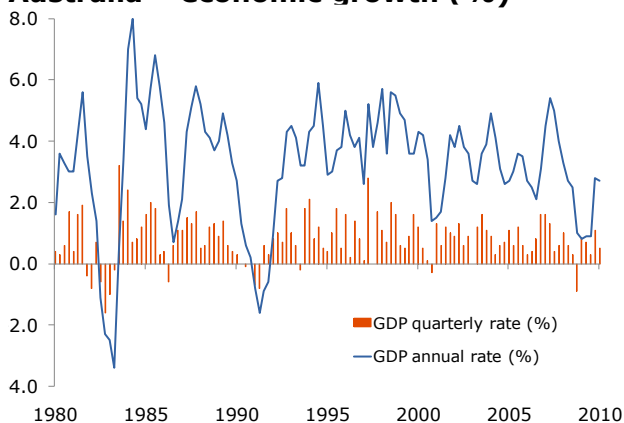
While a consensus seems to have been reached about the next step forward, Europe and the US are seemingly divided, with the US suggesting further stimulus is needed while Europe is fast tracking consolidation plans. The concern is the strict fiscal plans announced by Europe, if followed through, will result in weak growth from the region and could stifle global economic growth before the recovery is assured. Over the month a number of European countries announced further Budget cuts, with the focus on reforming pension systems, cutting government spending and lifting selected taxes.

China made headlines in June with steps to reform its currency. The People's Bank of China (PBOC) allowed the Renminbi to end its USD peg, with the currency to be determined with reference from a currency basket. The trading band was also widened (the changes revert the currency back to its regime prior to the GFC). Chinese officials cautioned there was no fundamental reason for appreciation of the Yuan, but by allowing these minor reforms to occur it does allow the currency to appreciate (or depreciate), albeit in a relatively limited way. This move reflects a level of confidence in the Chinese economy by officials and a generally more upbeat view of global economic conditions. What this should do over time is refocus the Chinese economy on domestic sources of economic growth rather than exports and help rebalance the economy to a more sustainable setting. Since these changes took place on 19 June, the

Yuan has appreciated roughly 0.6% against the USD.

In Australia the only economic data of note was released in the first two weeks of the month with Q1 10 GDP the highlight. The Australian economy recorded growth of 0.5%/qtr with annual growth holding steady at 2.7% (see chart below). Economic growth over the quarter was driven by further gains in public capital expenditure, which offset weakness in private capital expenditure and a solid increase in household consumption. One key positive was the boost to national income received from the terms of trade, assisted by elevated commodity prices. This optimistic growth outlook is conditional on private investment, particularly mining investment returning over the second-half of 2010, a resolution to the resources super profits tax and continued growth out of China.

Australia – economic growth (%)



Source: Colonial First State Global Asset Management

Other important data highlighted continued strength in the labour market. Since June 2009, 300k jobs have been added to the economy, with a further 26.9k added in May. The unemployment rate now stands at 5.2%, down from its recent peak of 5.8%. While the labour market reflects the strength in the Australian economy, this is not being reflected in consumer and business confidence, with both indicators falling in June. Concerns about a slowdown in Europe and China, uncertainty over the resources super profits tax (RSPT) and recent interest rates rises have weakened confidence levels. These measures, as well as income growth, will be crucial for the consumption outlook for the remainder of this year.

Australia had a change in Prime Minister over the month with Julia Gillard replacing Kevin Rudd following a change in the leadership of the Australian Labour Party. This isn't expected to have a large impact on the economy or financial markets. This has resulted in a change to the proposed RSPT in early July.

The changes centre around expanding the Petroleum Resources Rent Tax (PRRT) to both offshore and onshore gas, a new Minerals Resource Rent Tax (MRRT) will apply to iron ore and coal at a 30% tax rate with the uplift factor now 7% plus the long term government bond yield and concessions on the retrospective nature of the tax. These changes have resulted in a downgrade in estimated revenue from the tax from \$A12bn over the forward estimates to \$A10.5bn. As a result the government has made savings on the corporate tax rate cut, with a cut to 29% rather than 28%. The Government has committed the Budget back into surplus by 2012-13.

Australian shares

Offshore economic news and domestic politics were the focus for Australian equity investors in June. Negative sentiment towards global economic growth weighed on share prices and the general aversion to risk assets continued. The debate continued on the proposed introduction of the RSPT, while the change of Prime Minister to Julia Gillard was also a factor for markets.

In the lead up to the change in leadership there had been speculation the government would back down on some of the key components of the RSPT, with the new PM undertaking intense negotiations with the mining industry to come to a consensus on the tax. This would be a welcome development for all companies within the Materials and Energy sectors, with the Materials sector outperforming the broad index, falling 1.1%. The S&P/ASX 200 Accumulation Index declined 2.6% during the month taking returns over the financial year to 13.2%. This compares to return of -20.1% in the prior financial year.

The general mood of risk aversion saw the defensive sectors outperform in June. Telecoms (+9.5%), Utilities (+0.7%) and Consumer Staples (+0.5%) performed rose. The Telecoms sector was driven higher by Telstra (+10.5%), which reached a financial agreement with the Commonwealth Government over the proposed National Broadband Network.

Concerns over the global economic recovery saw companies exposed to offshore earnings amongst the bottom performers. Brambles (-17.9%), Macquarie Group (-14.3%), Qantas Airways (-12.0%) and Toll Holdings (-11.9%) were weak performers. Investors are keenly focussed on August reporting season.

With the end of the financial year, investors will now turn attention to the upcoming reporting season in August. Some companies have already flagged weaker earnings while others remain optimistic about the outlook for earnings growth. Any disappointing earnings releases are likely to be punished, given the volatility in markets and uncertainty over the economic recovery. The tone of outlook statements will have an important impact on investor sentiment.

Global shares

Global equity markets retreated in June on risk aversion and fears over the path of global economic growth. Uncertainty over financial regulation also provided a headwind with a bank levy proposed in UK, France and Germany while the US Congress continues its debate over regulatory overhaul package.

The MSCI World Net Index fell 3.4% in USD and -4.1% in AUD terms. The AUD experienced a rough ride over the month, but ended up appreciating 0.4% against the USD.

Regional performance was mixed with US, Europe and Japan recording negative returns while Asia saw gains. This largely reflects the different economic growth profile of each region and regulatory uncertainty, with Asia largely escaping regulatory uncertainty.

US equity markets retreated with mixed economic data. The Dow fell 3.6%, the S&P 500 was down 5.4% and NASDAQ retreated 6.6%. Over the financial year the Dow returned 15.7%.

European markets held up relatively well and outperformed US markets. The German DAX index was flat while France (-1.8%) and Spain (-1.0%) both fell. Greece was down 6.3% with expectations of a very weak economy.

In Asia, Japanese markets moved lower with the Nikkei falling 4.0%, to be down 5.8% over 12 months. While the Japanese economy has benefited from strong intra-Asia trade, concerns are still held over the country's ability to emerge from recession.

Elsewhere, Asian markets were higher. Hong Kong (+1.8%), Singapore (+3.0%) and Thailand (+6.3%) all rose. Over the past 122 months the Bangkok SET Index has been one of the top global performers, rising 33.5%.

On a sector basis, defensive sectors outperformed with Telecoms (+0.9%) and Food, Beverage & Tobacco (+1.5%) both rising. Among the weaker performers were Financials (-4.0%), Energy (-6.9%) and Retailing (-9.4%). The Energy sector was weighed down by BP, which fell 32.8% in June as it struggled to plug its Gulf of Mexico oil leak and clean up costs and brand damage escalated.

Global emerging markets

Emerging markets outperformed in June, although still recorded negative returns, Emerging economies are largely well placed in terms of government Budget deficit and debt positions.

The G20 summit communiqué detailed the focus of these economies will continue to be;

- Strengthening social safety nets, corporate governance and financial market development to lift savings and spending by the private sector.
- Lift infrastructure spending
- Enhance exchange rate flexibility.

The MSCI Emerging Markets Index fell 0.9% in \$US and 1.3% in \$A. Poland (-5.2%), Czech Republic (-6.2%) and Hungary (-4.8%) were among the weaker performers with concerns over growth and financial stability in Eastern Europe.

Equity markets in Latin America were also weaker, with Brazil (-3.4%), Mexico (-2.8%) and Argentina (-0.4%) also falling. Brazil lifted interest rates for the second time over the month and recorded annual growth of 9.0% for the 12 months to March 2010.

The strength in the sector was primarily driven by growth out of Asia, in line with developed markets. Sri Lanka (+8.9%) and the Philippines (+3.9%) both performed well.

Fixed interest

In the second half of the month, weaker than expected US employment data, signs of slowing in China, and concerns about measures to address the sovereign risk

situation caused bond yields to rally to new lows and credit spreads to continue to widen. The government bond market is now pricing in a stalling global recovery, and US Treasury yields are the lowest since the depths of the GFC in late 2008.

US Treasuries rallied, especially in the second half of June, when 10-year yields fell to new lows for this cycle, eventually closing out the month 37bps lower and below 3% for the first time since April 2009. The trend to lower yields was triggered by renewed risk aversion as a result of the sovereign risk crisis, but since uncertainties in Europe actually moderated in June, it appears that worries about the domestic economy's 'soft patch' were more dominant by month-end.

In Europe, German bunds rallied in most maturities across the curve in June. The reduced risk appetite that has been prominent in most global markets of late continued to bid bunds and Treasuries higher in price. The downgrade by Moody's to Greece's credit rating resulted in Greece dropping out of the index at the end of June. As a result portfolios were rebalanced leading to sell down of Greek bonds, Greek bond yields rose sharply and were also a supporting factor in buying German bunds.

In the UK, the release of a more austere emergency budget than expected saw gilt yields rallying, corporate credit spreads moving tighter, and the sterling appreciating against the dollar. Gilts outperformed and yields fell during the month as the tough budget is expected to slow growth. The 10-year yield fell by 23bps to 3.35%.

In Australia, the RBA left interest rates on hold at 4.50% in early June. In the accompanying statement, the RBA expressed concerns over global financial markets, especially developments in Europe and the resultant negative impact on investor sentiment. Given interest rates are now around average levels for borrowers, this allowed the RBA to keep the cash rate on hold in the 'near-term'. The RBA retains a relatively upbeat outlook for the domestic economy and expects inflation will be in the upper half of the target zone. Given offshore factors and some weaker economic data at home, financial markets have pushed out the chance of a further near-term rate hike. The RBA still retains a tightening bias,

but further moves in the cash rate will likely be dependent on Q2 10 inflation data released late July, signs of stability in financial markets and a change in the mix of growth from government investment to the private sector.

The market has been pushing out interest rate moves by the RBA as a result of global economic issues and softer data in Australia. As a result Commonwealth government bonds yields fell 28bps over the month and ended June at 5.10% respectively.

The UBS All Maturities Composite Bond Index returned 1.37% in the month and 7.86% over 12 months.

Listed property

Australian listed property securities lost value in June, although the sector fared better than the broader share market. The S&P/ASX 200 Australian Real Estate Investment Trust (AREIT) Accumulation Index declined 0.8% during the month. June saw renewed investor interest for the AREIT sector by both domestic and offshore investors. Relatively appealing valuations and improved balance sheets have improved the outlook for the sector.

The sub-sectors within the listed property sector produced a large variance of returns. The retail sector fell 3.3% and was the worst performer over the financial year, although returned a positive 16.2%. The Industrial sector rose by 2.8% in June, and was the top performer over the past 12 months, rising 88.8%. This was assisted by gains in Goodman Group (+3.8%) and GPT Group (+6.4%). Late in the month, GPT Group announced its fund raising for its Office Fund had been oversubscribed, demonstrating the renewed enthusiasm for the AREIT sector, particularly office space which is benefiting from strength in the Australian labour market. Over the past 12 months, 300k jobs have been added, driving demand for office space. Diversified (+1.2%) and office (+2.0%) also both rose.

Global property securities also came under downward pressure, consistent with the declines in major global equity indices, albeit faring a little better. The UBS Global Investors Index fell 2.9% in June although there was substantial difference in performance between markets. The US, the UK and Japan all recorded negative returns while China, Hong Kong, Canada and France were positive.

Index performance

| Index returns – June 2010 | Level | 1 month (%) | 12 month (%) |
|--|-----------------------|-------------|--------------|
| S&P/ASX200 Index | 4,302 | -7.9 | 16.0 |
| S&P/ASX 200 Accumulation Index | 30,610 | -2.6 | 13.1 |
| MSCI World Net Index (AUD) | - | -4.1 | 5.5 |
| MSCI World Net Index AUD Hedged | - | -3.8 | 14.0 |
| Dow Jones Index | 9,774 | -7.9 | 19.2 |
| UK FTSE 100 | 4,917 | -6.6 | 17.4 |
| German DAX Index | 5,966 | -2.8 | 20.7 |
| France CAC Index | 3,443 | -8.1 | 7.0 |
| Japan - Nikkei | 9,383 | -11.7 | 2.6 |
| Hong Kong – Hang Seng | 20,129 | -6.4 | 8.8 |
| MSCI Emerging Markets Net Index (AUD) | | -1.4 | 17.9 |
| US 10 year bond yield | 2.93% | -37bps | -17bps |
| Australia 10 year bond yield | 5.09% | -34bps | 9bps |
| UBS All Maturities Composite Bond Index | 6,146 | 1.4 | 7.9 |
| 90 Day Bank Bill Index | 4.92% | 24bps | 168bps |
| UBS Australian Bank Bill Index | 6,918 | 0.4 | 3.9 |
| S&P/ASX 200 - A-REIT Accumulation Index | 18,884 | -0.8 | 20.4 |
| UBS Global Real Estate Investors Index (Net TR) AUD Hedged | 986 | -2.9 | 39.1 |
| AUD/USD (end of month) | 0.8467 | -9.0 | 5.4 |
| Oil price | \$US75.63 /barrel | -14.1 | 11.6 |
| Gold price | \$US1241.65 /ounce | 3.2 | 24.6 |

Source: Colonial First State. Data to 30 June 2010. **Past performance is no indication of future performance.** These index returns do not reflect the performance of any Colonial First State fund or investment option. For returns for any Colonial First State Fund or investment option please refer to the performance section of the Colonial First State website available at colonialfirststate.com.au.

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